Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, TRUSTEE,
PETITIONER,

vs.

RELIANCE INSURANCE COMPANY,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE JOHN G. STREET, JR. IN SUPPORT OF PETITIONER

JOHN G. STREET, JR.
Amicus Curiae
625 Fort Worth National Bank Bldg.
Fort Worth, Texas

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TO THE HONORABLE SUPREME COURT
OF THE UNITED STATES:

THE INTEREST OF THE AMICUS CURIAE

Your amicus curiae is the attorney for Burton B. Paddock, Trustee in Bankruptcy for Stanford Con-

struction Company, which was adjudicated a bankrupt in Cause No. 2439 in bankruptcy in the United States District Court for the Northern District of Texas, Fort Worth Division; Trustee Paddock took over and completed two of his Bankrupt's contracts; the Bankrupt's bonding company, New Amsterdam Casualty Company, after the adjudication of bankruptcy made payments under the payment bond to unpaid laborers and materialmen. Hon. John Ford, Referee in Bankruptcy, held that the bonding company did not have a preferred claim to the retainages and payments due under the two contracts but should share in the proceeds with the other general creditors. The bonding company's petition for review is now pending in the United States District Court for the Northern District of Texas, Fort Worth Division. When the case at bar was before the Second Circuit, this *amicus curiae* filed, with the permission of that Court, an *amicus curiae* brief. This Court's decision will have an important bearing on the ultimate decision of the case involving the *amicus curiae's* client. This *amicus curiae* is vitally interested in the Court being as fully informed as possible in regard to the law involved. On June 25, 1962, this Court granted permission for the filing of this brief.

ARGUMENT

The opinion of the Second Circuit stated that the question to be decided was whether the surety who made payments under a payment bond is entitled by way of subrogation to the fund paid to the Trustee in Bankruptcy by the Government for work done prior

to the termination of the contract. (R. 52) The lower court then went on to say that it disagreed with the decisions in the Ninth and Tenth Circuits in *Phoenix v. Earle, 9 Cir. 1955, 218 F.2d 645* and *American Surety Co. v. Hinds, 10 Cir. 1958, 260 F.2d 366*, "holding the surety not entitled to subrogation." (R. 52-53) The Second Circuit was in error in this regard because both the *Hinds* and *Earle* cases held that the surety was subrogated to the rights of the laborers and materialmen, but that since laborers and materialmen have no enforceable rights against the United States, the surety could rise no higher than the basis of the subrogation, and thus the surety was only a general creditor, as it stood in the same position as those it had paid. The following language from the *Hinds* case at page 368 of the opinion is clear and concise as to what that court was holding:

> "The rights of a surety are largely derivative in nature. Having paid the laborers and materialmen, appellant may claim subrogation to their rights. But since laborers and materialmen have no enforceable rights against the United States the surety can rise no higher than the basis of the subrogation. The very purpose of the payment bond required under the Miller Act is to shift the ultimate risk of nonpayment from workmen and suppliers to the surety. The United States does not retain funds for that purpose for it is said:
>
> "'But although we have assumed, for the purposes of another argument, that assurance that laborers and materialmen will be paid is one of the reasons for retaining the money, it

> seems more likely that completion of the work on time is the only motive. [Citations] It is hardly reasonable to withhold money in order to assure payments which perhaps can be made only from the money earned. In any event, we are not prepared to apply law relating to security to unappropriated sums which exist only as a claim.' United States v. Munsey Trust Co., 332 U.S. at Page 243, 67 S.Ct. at page 1603.
>
> "It would seem clear that if the surety can claim no enforceable right of subrogation through the creditors paid and can assert no equitable claim to the fund itself, either in its own right or through the United States, then the Trustee must here prevail and appellant's claims must await their presentation under the administration of the bankruptcy proceedings. The Ninth Circuit has similarly concluded in Phoenix Indemnity Co. v. Earle, 218 F.2d 645."

The Second Circuit compares the *Heard Act, 33 Stat. 811 (1905)* and the *Miller Act, 40 USC, Sec. 270a (1935)* (R.54-56), and then says that the United States Government was under " 'equitable obligations to see that the laborers and supply men were paid,' ", (R. 56). If any such "equitable obligations" ever existed, it passed out of the picture when the *Miller Act* was passed requiring that a separate payment bond be furnished to insure the payment of laborers and materialmen. Prior to the *Miller Act* only one bond was required. The *Miller Act, 40 USC Sec. 270a*, provides for (1) a performance bond "for the protection of the United States," and (2) a payment bond "for the protection of all persons supplying labor and material". With the government requiring a good,

solid bonding company to be ready to pay any unpaid laborers or materialmen, who could fairly claim there was any other obligation owed by the United States Government—legal, moral, or otherwise—to the laborers and materialmen? For the sake of argument, assume that there was an "equitable obligation" on the part of the United States Government to see that the laborers and materialmen were paid. So what? Is there any right reposing there that a laborer or materialman could enforce against the United States? Of course there is none? *United States use of Hill v. American Surety Co., 200 U.S. 197, 203, 26 S.Ct. 168, 50 L.Ed. 437, 440; Equitable Surety Co. v. United States, use of McMillian, 234 U.S. 448, 455, 34 S.Ct. 803, 58 L.Ed. 1394, 1397; United States v. Munsey Trust Co., 332 U.S. 234, 67 S.Ct. 1599, 91 L.Ed. 2022, 2028.* In order to acquire a right by subrogation there must be an enforceable right to start with. There is no enforceable right on the part of a laborer or materialman against the United States Government, and the surety cannot acquire by subrogation what is not there to start with. This Court in *Munsey*, supra, stated that: " . . . nothing is more clear than that laborers and materialmen do not have enforceable rights against the United States for their compensation." *(332 U.S. 234, 241, 91 L.Ed. 2022, 2028)* It was also held by this Court in *Munsey* that: " . . . it is elementary that one cannot acquire by subrogation what another, whose rights he claims, did not have. Once the laborers and materialmen have been paid, whether by contractor or surety, they have no rights in any fund." *(332 U.S. 234, 242, 91 L.Ed. 2022, 2029).*

The Second Circuit makes the statement that:

> "Moreover, the fact that 'laborers and materialmen have no enforceable rights against the United States,' 260 F.2d at page 368, is beside the point. The question is not whether the laborers and materialmen have rights enforceable against the Government, but whether they have an equitable priority in the retained payments." (R.57)

What kind of Mumbo Jumbo is that? If a person has a priority, whether it be by virtue of an equitable cause of action or an action at law, he has an enforceable right. If he has no enforceable right he has no priority.

This Court held in *Munsey* that the United States is under no legal obligation to pay the laborers and materialmen. If the United States is not legally liable to laborers and materialmen, then it must follow that the laborers and materialmen have no legal remedy and that the surety can acquire none by way of subrogation. The Second Circuit has in effect held that the laborers and materialmen on a job for the United States have some sort of nebulous, unenforceable right against the United States that by subrogation is turned into an enforceable right on the part of the surety.

In *Munsey* this Court indicated that it felt it more likely that completion of the work on time is the only motive for the United States of America retaining payments prior to completion. That the retainage is retained by the government for the sole purpose of insuring completion of the project is shown by the

statutory provision that appears in almost all United States of America contracts which provides that the contracting officer, at any time after 50% of the work has been completed, if he finds that satisfactory progress is being made, may make any of the remaining partial payments in full, and that on completion and acceptance of each separate building, public work, or other division of the contract, on which the price is stated separately in the contract, payment may be made in full, including retained percentages thereon. There is no requirement that a contractor prove that he has paid his laborers and materialmen before he is entitled to payment.

The Ninth Circuit has also held in line with the petitioner's position in the case of *Phoenix Indemnity Company v. Earle (Ninth Cir. 1955) 218 F.2d 645.* That case involved the question of priority as between United States tax liens and a surety which had paid materialmen and laborers of the prime contractor. In that case the contractor completed the job. Before any payments were made by the surety and before bankruptcy, the government filed tax liens. After the tax liens were filed the surety paid under its payment bond $15,210.60 for labor and material. The United States Government paid the balance due under the contract of $11,838.61 to the trustee in bankruptcy. In holding that the tax liens were superior to the claim of the surety, the court stated that it is true the surety is subrogated to the rights of the creditors whose claims it paid, but *that those creditors (the laborers and materialmen of the prime contractor) had no lien or oth-*

er enforceable right against the agency of the United States Government or the funds owing to the bankrupt contractor. The Court stated that the claims of laborers and materialmen against the estate of the bankrupt are general and unsecured, and that *Section 57, Sub. i (11 U.S.C.A. § 93, Sub. i)* confines the secondary debtor to a proof of the creditor's claim in the creditor's name.

In its opinion the Second Circuit cites *Henningsen v. U. S. Fidelity & G. Co. (1907) 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547,* for the proposition that the Government is under an equitable obligation to see that the laborers and supply men were paid. Of course, after *Henningsen* was decided, the *Miller Act* was passed which provided for a separate payment bond for laborers and materialmen. Also, the *Henningsen* case was not well reasoned as *Prairie State Natl. Bank v. U.S., 164 U.S. 227, 17 S.Ct. 142, 41 L.Ed. 412,* the only case relied upon by the Court in *Henningsen,* was not in point. *Henningsen* was a "payment bond" case involving payments by the surety to unpaid laborers and materialmen, and the surety had not completed the job. The *Prairie State National Bank* case was a performance bond case in which the surety took over and completed the unfinished contract, and that Court held the surety was entitled to the retainages because if the United States had been forced to complete the job it could have used the retainages for completion.

The Second Circuit cites *Belknap Hardware & Mfg. Co. v. Ohio River Construction Co., 6th Cir. 1921, 271*

Fed. 144, (R. 55), with the statement that the Belknap case commented upon the *Henningsen* case and spelled out "in no uncertain terms" the priority of materialmen and laborers. When the *Belknap* case is analyzed it is not in point because (1) the bond did not have anything to do with the matter—the Court stating at page 146:

> "Further, we cannot see that the bond has anything to do with the matter. A judgment on the bond would be worthless, and the claimants do not ask any such judgment. While the only purpose of the statutory bond is to enable the United States and materialmen and laborers to collect from the sureties their claims against the contractor, it may be (the point has not been argued and is not decided), that, if claimants have an equitable priority in the fund over mere general creditors, the relations between themselves and the sureties may also give them priority over the claims of the sureties for material and labor, if such claims they have; but with this exception, we think whatever is said about the bond in the bill of complaint is surplusage, and we must look to the remainder to find a meritorious case."

(2) the laborers and materialmen in the *Belknap* case had not been paid; (3) the surety in the *Belknap* case was insolvent; (4) the *Miller Act* has been passed since the *Belknap* case was decided and requires a separate payment bond for the protection of laborers and materialmen, whereas, there was only one bond required at the time the *Belknap* case arose and the United States had a priority for the full satisfaction of all its claims for completion or delay before any protec-

tion was afforded the unpaid laborers and materialmen. In quoting from the *Belknap* case, the Second Circuit omitted from the middle of its quotation the more interesting language of the opinion (R. 55). The two sentences, which were omitted in the court's quotation from the *Belknap* case are as follows:

> "The case [Hennigsen] was essentially different from the Prairie State Bank case, because there the surety had taken over and completed the contract and the performance of the contractor's obligation to the United States as the other party to the contract, and so had become entitled to the security which the United States held against the contractor; in the Henningsen Case, the contractor himself had completely performed the contract and had finished the work. It would seem, therefore, that subrogation in the Henningsen Case could not be to any security which the United States held against the contractor; there was no such element in the case."

The Court in the *Belknap* case recognized that the *Prairie State Bank* case was "essentially different" from the *Henningsen* case. This points up the fact that the *Henningsen* case is wrong, and the reason the Court arrived at the wrong result in the *Henningsen* case was because it thought the *Prairie State Bank* case was in point, when it clearly was not. The Court in *Henningsen* made the statement, "Prairie State Nat. Bank v. United States, 164 U.S. 227, 41 L.Ed. 412, 17 Sup. Ct. Rep. 142, is in point."

The *Belknap* case then "backs in" to the decision of the case by saying that since *Henningsen* said there

was subrogation, even though the *Prairie State Bank* case upon which *Henningsen* relied was not in point, there must have been some right to which the surety was subrogated, even though *Henningsen* did not say what the right was. This is a perfect example of putting the cart before the horse. The Court in the *Belknap* case indicates at page 149 that the right to which the surety was supposedly subrogated was not stated in very express terms in the *Henningsen* opinion. That is somewhat of an understatement—the supposed "right" was not described at all.

The Second Circuit, after referring to the legislative history of the Miller Act. (R. 56), says that the purpose of both the Heard and Miller Acts was to make sure that the materialmen and laborers "should be secured out of *the job itself* rather than on the general credit of the prime contractor." [Emphasis supplied] That just was not the purpose. If a materialman's or laborer's payment is secured "out of the job itself", it can only mean that he has a lien on the "job". A materialman or laborer has no lien on a Government job. He had none under the Heard Act, and he had none under the Miller Act. The purpose of Congress in passing the Miller Act was to require a payment bond that the materialmen and laborers could look to for payment. It would have made very interesting reading if the Second Circuit would have detailed steps by which a materialman or laborer allegedly can secure his payment "out of the job itself." In the Appendix to this brief is copied all of the Congressional history on the Miller Act that this writer could find. There is not one thing in that his-

tory to indicate Congress thought the materialmen and laborers could be secured "out of the job itself". Instead it clearly shows that the purpose was to require a separate payment bond out of which the materialmen and laborers would be paid.

Mr. Miller, in explaining the purpose of the Miller Act to his fellow Representatives, stated that the Act " . . . provides for two bonds, *one for the protection of the Government's interests*, and *the other for the protection of the rights of labor, the subcontractors, and material furnishers.*" *79 Congressional Record 11702.* [Emphasis supplied] Mr. Miller was telling the House of Representatives that the performance bond would protect all of the "Government's interests". If the laborers and materialmen on a Federal project had any enforceable rights against the Government, Representative Miller would not have indicated that all the Government's interests were protected by the performance bond; he would have included the Government as being protected by the payment bond—but he didn't, for he knew materialmen and laborers had no enforceable rights against the Government in connection with work on a Federal project.

In the Senate, Senator Burke indicated the performance bond was for the protection of the Government and the payment bond for the protection of materialmen and laborers. *79 Cong. Record 13382.*

The *Restatement, Security* § *141, pages 383-384,* discusses the meaning of subrogation. It says at page 384 that subrogation " . . . is a mode which equity

adopts to compel the discharge of a debt by the one who in good conscience ought to pay it." This shows that the surety company should not obtain a preference over the general unsecured creditors of the bankrupt, because there is no one to whom the surety can point and say: "In good conscience you ought to pay my claim ahead of all others." At page 384 the *Restatement, Security further states:*

> "Subrogation, as a creation of equity, is subject to the limitation that it will not be allowed where it will prejudice the creditor or be inequitable to third persons."

Even if there were any enforceable rights to which the surety could be subrogated, it would be inequitable to prefer the surety, which knowingly assumed the risk for a premium, over general unsecured creditors of the bankrupt, and subrogation should not be allowed.

If the Trustee prevails in this case, the surety company will not suffer any great loss, for it will receive a pro rata share of the dividends along with the other general unsecured creditors. As stated in *American Surety Co. v. Sampsell, 1945, 327 U.S. 269, 274, 66 S.Ct. 571, 90 L.Ed. 663, 667,* equitable principles govern the distribution of a bankrupt's assets. The surety company has received a premium for the risk it took on the payment bond, while the other general creditors were not so fortunate. It would certainly comport with equitable principles to allow the general creditors to share equally with an insurance company surety who received a premium to take a known risk. In the

Sampsell case, supra, this Court held that a surety company which had paid laborers and materialmen up to the limit of its bond could not share in bankruptcy dividends so long as there remained unpaid any creditor of the class for whose protection the bond was intended, even though the unpaid creditors may not have complied with statutory provisions in regard to notice and filing.

If this Court were to hold that a surety which makes payments under its payment bond without doing anything in connection with its performance bond has a prior claim over general creditors of a bankrupt contractor, it would lead to the anomalous result that if a Trustee had taken over and completed a contract of his bankrupt, a surety company which made payments under its payment bond after bankruptcy would have a prior claim to the Trustee (who represents the general creditors). The writer represents a Trustee in this exact situation—on the date of bankruptcy two jobs for the United States of America were not completed; the Trustee took over and completed the two jobs; the bonding company, after bankruptcy, made payments under its paymend bond in satisfaction of debts incurred by the contractor with laborers and materialmen prior to the date of bankruptcy, and the bonding company is contending that it is entitled to receive the contract funds.

CONCLUSION

It is respectfully submitted that this Court should reverse the decisions of the Second Circuit and the

United States District Court for the Western District of New York and affirm the decision of Referee in Bankruptcy, James R. Privitera. This would result in an equitable solution of the case as Respondent, Reliance Company, would share pro rata with the other general unsecured creditors.

Respectfully submitted,

John G. Street, Jr.
Amicus Curiae

I hereby certify that I have served a copy of the foregoing brief on Hon. Raymond T. Miles, 942 Ellicott Square Building, Buffalo 3, New York, Petitioner's counsel of record, and Hon. Mark N. Turner, 440 M & T Building, Main and Swan Streets, Buffalo 2, New York, Respondent's counsel of record, by depositing, on August 3, 1962, a copy of same in a United States mail box with airmail postage prepaid, addressed to each of the above-named counsel of record at the post office address set forth above.

John G. Street, Jr.
Amicus Curiae

APPENDIX

At *79 Congressional Record 11702* appear the following proceedings of the House of Representatives:

* * * (Omitted is Mr. Miller's request for unanimous consent for consideration of the bill and Mr. Martin's request for an explanation of the bill)

"Mr. MILLER. This bill merely provides that in the construction of public buildings and other public works there shall be two bonds, one for the performance of the contract with the Government, and the other a payment bond for the protection of subcontractors and those furnishing the labor and material.

Under the present law we have but one bond, with a dual obligation, but it is not satisfactory in that it does not afford protection to the subcontractors, materialmen, and laborers.

This merely provides for two bonds, one for the protection of the Government's interests, and the other for the protection of the rights of labor, the subcontractors, and material furnishers. It permits the filing of a suit on the payment bond 90 days after the work has been done, or material furnished.

"Mr. MARTIN of Massachusetts. It gives protection to the subcontractors."

"Mr. MILLER. That is right.

"Mr. MARTIN of Massachusetts. Was it a unanimous report from the committee?"

"Mr. MILLER. Yes; so far as I know, no opposition developed.

"The SPEAKER. Is there objection?

"There was no objection.

"* * * (The Clerk read the bill).

"The bill was ordered to be engrossed and read a third time, was read the third time, and passed, and a motion to reconsider was laid on the table."

At *79 Congressional Record 13382* appear the following proceedings of the Senate:

"Mr. McKELLAR. Mr. President, may we have a statement as to this bill?

"Mr. METCALF. Mr. President, I have just received a communication from certain builders who asked if they could not have a hearing on an amendment they would like to have attached to this bill. I know nothing about the bill, not having read it, but I understand there will be no objection to taking this course.

"Mr. McKELLAR. Let it go over.

"Mr. BURKE. Mr. President, I should like to make a statement regarding the bill.

"The PRESIDING OFFICER. Does the Senator from Tennessee withhold his objection?

"Mr. McKELLAR: I withhold the objection.

"Mr. BURKE. Mr. President, this bill proposes to amend what is known as the "Heard Law." It provides, in the case of contracts with the Government in an amount more than $2,000 that the contractor shall be required to give two bonds instead of one, as at the present time. Under the present law a performance bond is given for the protection of the Government. This bill would amend that law by requiring an additional bond, a payment bond, for the protection of materialmen and laborers, subcontractors, and all who put forth their labor or furnish materials or incur expenditures in connection with the work.

The House Judiciary Committee held hearings on the bill, all the different groups were represented, and this bill was finally passed by the

House. The Senate committee did not hold any hearings.

"Mr. WALSH. Mr. President, will the Senator yield?

"Mr. BURKE. I yield.

"Mr. WALSH. Is this an amendment to the Bacon-Davis law?

"Mr. BURKE. This is an amendment to what is known as the 'Heard Act.'

"Mr. WALSH. As I understand, the bill will require a contractor, in furnishing a bond, not only to be liable for default by reason of his inability to complete the contract or by reason of failing to meet the requirements and specifications as to material, but will require him to meet the claims of workers and employees who do not receive their compensation.

"Mr. BURKE. That is the point exactly.

"Mr. WALSH. Of course, it is a most meritorious bill, and should be enacted.

"Mr. McCARRAN. Mr. President, will the Senator from Nebraska yield to me?

"Mr. BURKE. I yield.

"Mr. McCARRAN. It will do just a little more than what the Senator from Massachusetts has in mind. In other words, under the existing law one who has furnished material or labor in the construction of a Federal building must wait for 6 months after the acceptance of the building before he may institute suit to recover on the obligation to him. This bill, as I now recall, changes that situation so that he may sue within 90 days.

"Mr. ASHURST. That is correct.

"Mr. McCARRAN. To that extent it works to the benefit of the materialman and the laboring man as well.

There are two points involved, one relating to the performance of the contract. The other is that the materialman and the laborer may sue and be heard within a shorter time than under the existing law.

"Mr. WALSH. Mr. President, I will say to the Senator from Nevada and to the Senator from Nebraska that the investigation conducted by the subcommittee of the Committee on Education and Labor showed a deplorable condition with reference to the way employees on public buildings were defrauded and cheated of their wages, and any measure that will tend to strengthen their rights and help them secure their compensation is justified.

"Mr. McCARRAN. That is the object of the pending bill, and I might augment what the Senator from Massachusetts has said as to what has been shown by the hearings to which he has referred.

"Mr. WALSH. I did not believe it was possible for men repeatedly to get contracts from the Federal Government and chisel, the way some of them do, against the wages of the employees.

"Mr. ROBINSON. Mr. President, may I ask what objection is urged to the bill?

"Mr. ASHURST. There is no objection.

"Mr. ROBINSON. It is apparent that if the bill is to be considered, no opportunity can be afforded now to hold hearings on it. That would carry it over for the session.

"Mr. METCALF. Mr. President, I withdraw my objection.

"The PRESIDING OFFICER. Is there objection to the present consideration of the bill?

"There being no objection, the Senate proceeded to consider the bill, which was ordered to a third reading, read the third time, and passed.